

**STATE OF WASHINGTON  
STATE INVESTMENT BOARD**

Public Markets Committee Meeting  
Minutes

March 4, 2003

The Public Markets Committee met in open public session at 1:02 P.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Members Present: Charles Kaminski, Chair  
Debbie Brookman  
Glenn Gorton  
Jeff Hanna (teleconference)  
Patrick McElligott  
Robert Nakahara  
Lee Ann Prielipp

Other Board Members Present: George Masten

Members Absent: Representative Sommers

Others Present: Joe Dear  
Gary Bruebaker  
Bill Kennett  
Nancy Calkins  
Diana Will  
Tom Bosworth  
Linda Esau  
Linda Lester  
Donna May Ong  
Ralph Ripple  
Maria Tosteson Rosen  
Judy Yu  
Kristi Bromley  
  
Jim Keagy, Barclays Global Investors  
Alan Mason, Barclays Global Investors  
David Rothenberg, Barclays Global Investors  
Amy Schioldager, Barclays Global Investors  
  
Tom Ryan, Frank Russell  
Bob Werner, Frank Russell  
  
Sue Bonfeld, State Street Global Advisors  
Jim Francis, State Street Global Advisors  
Ross McLellan, State Street Global Advisors  
  
Steven Glass, The Plexus Group  
Vinod Pakianathan, The Plexus Group

The meeting convened at 1:02 P.M. with Chair Kaminski identifying members present.

**REVIEW AND APPROVAL OF MINUTES – FEBRUARY 4, 2003**

**Ms. Prielipp moved to adopt the Public Markets Committee minutes of February 4, 2003. Mr. McElligott seconded.**

Chair Kaminski noted revisions to the minutes pertaining to a reference in the BlackRock finalist interview and a wording change to comments made by the Chair during the discussion following the finalist interviews.

**The minutes, as amended, were adopted unanimously.**

**FIXED INCOME – MANAGER PRESENTATION AND PORTFOLIO REVIEW**

Mr. Kennett presented the Fixed Income portfolio review as of December 31, 2002. He provided a market review of 2002, noting interest rates hit forty-year lows, geopolitical risks were high, there was one Federal Reserve Bank easing, inflation was in check and deflation did not appear, slow gross domestic product (GDP) growth, record corporate defaults, record mortgage refinancing, corporate pension under funding, explosive growth in credit derivative market, the biggest swing in the federal budget in history, and significant volatility in both interest rates and yield spreads. He reviewed the Lehman Universal and Lehman Aggregate index returns for 2002. Mr. Kennett noted that, across all the fixed income portfolios, treasuries and mortgages did very well and credits performed poorly.

Mr. Kennett reviewed the 2003 outlook for the fixed income market, stating that the market is on hold until there is some resolution of the Iraq situation. He noted that geopolitical uncertainties would continue even with a successful resolution to the situation in Iraq given continuing concerns about North Korea and terrorism. He also noted that the fourth quarter GDP results reveal a stagnant economy. Further review of the 2003 outlook include a muted recovery, low inflation, fed on hold until late in the year, higher short rates toward year-end, continued spread volatility, less corporate issuance, low single digit returns for the fixed income asset class, consumer spending slowdown, business investment turning around with manufacturing, government spending and tax cuts providing a stimulus, but the size of the federal deficit a concern, and net exports being a large drag on the economy and a threat to the strength of the dollar.

The portfolio strategies for the retirement portfolio included shortening the duration of the non-TIPS portfolio, reducing holdings of nominal Treasuries, maintaining credit allocation of approximately 40 percent, remaining underweight high yield, remaining overweight emerging markets, increasing mortgage backed securities holdings, and reducing commercial mortgage-backed securities exposure but maintaining overweighting.

Discussion ensued regarding reducing the duration of the retirement portfolio, using bank loans as an alternative to high yield bonds, and the relative attractiveness of real yields and breakeven levels of TIPS.

Mr. Kennett provided further review of the retirement fixed income portfolio, noting that the average quality was AA2, slightly less than that of the Lehman Universal. The credit weighting

at the end of December was at 38.3 percent, compared to 34.3 percent for the Lehman Universal, and down from 58 percent at the beginning of the year. He reviewed the credit quality held in the portfolio versus the Lehman Universal, noting that the retirement portfolio held less high yield, less debt below BBB, was underweight U.S. high yield, and overweight emerging markets. He reviewed the differences between the returns of the retirement portfolio versus the Lehman Universal for the one-, three-, and five-year periods, noting that for the three- and five-year periods the retirement portfolio outperformed by approximately 30 basis points (bp) a year. He also noted that the portfolio was down 19 bp for the year, and up approximately 150 bp fiscal year-to-date as of the end of February. He provided a review of performance by sector, noting that credits had a terrible year, down 300 bp, and that Treasuries, TIPS and mortgages did well. Mr. Kennett reviewed the performance attribution of the retirement portfolio by sector and security decisions, noting that over the six-year period, security selection was good and sector selection was neutral.

Mr. Hanna noted it was interesting that, while the retirement portfolio has historically been underweight mortgages, most years the portfolio's mortgage holdings performed better than the Lehman Universal. He stated that this was commendable, and that the mortgage portfolio did better than the overall retirement fund for every year, even when many mortgages suffered from adverse convexity. He contrasted this to the credit holdings, where there were many years when the credit portfolio did worse than the retirement portfolio as a whole. He stated that he believes this calls into question the strategy of overweighting credits to improve returns.

Mr. Kennett reviewed the Labor & Industries' (L&I) funds' strategic goals, which are to maintain solvency, rate stability and sufficient assets to pay liabilities. He noted that two of the funds with longer liabilities use dollar duration asset-liability matching. He reviewed the performance of the L&I funds, noting that the Accident and Medical Aid funds contained equities and that was why their returns were lower than fixed income returns in general. He reviewed the poor performance of the Supplemental Pension fund due to credit holdings and cash drag.

He reviewed the performance of the Intermediate Bond Fund, which was down over 200 bp versus the index over the year. He noted that the riskier credits were sold in this fund. WorldCom alone cost this fund 100 bp in performance. Mr. Kennett noted that, while previous holding levels were within policy ranges, individual credit holdings have been reduced to lower the risk to the portfolio.

## **PUBLIC EQUITY – EDUCATIONAL SESSION ON TRANSITION MANAGEMENT**

Mr. Bruebaker stated that this was the first of a series of educational sessions to be held over the next few months, which will result in a review of the structure of the international equity program. He noted that The Plexus Group (Plexus) would present "Transition 101," followed by Barclays Global Investors (BGI) and State Street Global Advisors (SSgA) presenting a specific case study based on a transition from the Wilshire 5000 (W5000) to the Russell 3000 (R3000), and Frank Russell Company providing a wrap-up.

### **Plexus**

Mr. Glass introduced himself and Vinod Pakianathan. He began his overview of transition management by noting that, while inefficient transitions can be costly, the costs can be minimized by managing execution risk, operational risk, political risk, and performance risk. He reviewed keys to prudent transition management, decisions that plan sponsors should make up-front, transition mechanics, and the importance of a post-transition analysis.

BGI

Mr. Rothenberg introduced himself and Mr. Mason. He reviewed BGI's approach to transition management, and focused on five key transition issues and questions: experience, focus on transition management, internal crossing capability, liquidity sources, and maximization of securities lending revenue. Mr. Mason reviewed the impact for the WSIB of a transition from the W5000 to the R3000, annual return differentials between the two indices, and various transition scenarios.

SSgA

Ms. Bonfeld introduced herself and Mr. McLellan. Mr. McLellan reviewed SSgA's transition capabilities, including their transition philosophy, competitive advantages, crossing capabilities, and results. He reviewed SSgA's indicative results for a W5000 to R3000 transition, including trading and costs analysis.

Frank Russell

Messrs. Ryan and Werner introduced themselves. Mr. Werner noted that, while Russell is mainly known for its consultant services, it has also managed numerous transitions. As a consultant and fiduciary, it has measured the outcomes of hundreds of transitions and has a lot of information on the actual outcomes of these events. Mr. Werner reviewed the importance of the objective of a transition, which he sees as having the least impact on investment returns with the goal being market appreciation during the transition period and not merely principal protection: "Did the fund earn the investment returns it should have even during the transition period?" He reviewed transition costs, taking into consideration investment performance, presented two transition case studies, and assumptions for a WSIB transition from the W5000 to the R3000.

A question and answer period ensued, including other types of transitions (i.e., active to active, active to passive, passive to active), what the WSIB could do to protect itself from the adverse affect of advance public knowledge on a transition, differences between the W5000 and R3000, and differences amongst transition managers.

[The Committee recessed at 3:05 P.M. and reconvened at 3:14 P.M.]

**PUBLIC EQUITY – INDEX MANAGER PORTFOLIO REVIEWS**

State Street Global Advisors – Non-U.S.

Ms. Bonfeld introduced herself and Mr. Francis. She provided a performance summary and reviewed total assets under management. Mr. Francis reviewed the structure of SSgA's Global Structured Products Group, indexed assets under management, and its focus on research.

Mr. Francis reviewed SSgA's liquidity tier emerging markets strategy, which consists of 22 countries and currently uses an IFC liquidity tier benchmark. He reviewed the history of the liquidity tier strategy, including the original purpose of the strategy, the definition of "investability," criteria for constructing liquidity tiers, and the advantages of using liquidity tiers. Discussion ensued regarding investor interest in the Morgan Stanley Composite Index (MSCI) All Country World Index (ACWI), ACWI mandates, and investor moves to active emerging markets mandates rather than passive management. Mr. Francis reviewed liquidity tier benchmark weights, and discussion ensued regarding pros and cons of rebalancing and timing of rebalancing.

[Mr. Hanna was no longer in attendance at 3:46 P.M.]

Barclays Global Investors – U.S.

Mr. Keagy introduced himself and Ms. Schioldager, and provided an overview of BGI. Ms. Schioldager reviewed the portfolio characteristics of the U.S. equity portfolio, including top ten stock holdings and sector diversification, and reviewed fund performance. She reviewed their team based approach, investment process, portfolio management, and the impact of 2002 events on the portfolio.

[Mr. McElligott was no longer in attendance at 4:18 P.M.]

**PUBLIC EQUITY – THE PLEXUS GROUP, INC. TRADE EXECUTION ANALYSIS**

Mr. Glass reintroduced himself and Mr. Pakianathan. He reviewed their approach to measuring and benchmarking trade costs, and noted Plexus' definition of transaction costs: "How much did you pay, from the assets of your fund, to buy and sell stocks in your portfolio?" He reviewed the component parts of transaction costs: commission, market impact, and delay costs, and noted the tension between market impact and delay costs, where minimizing one area tends to increase another. Mr. Glass stated that the challenge is to minimize the aggregate transaction costs and to match trading strategy to investment mandate.

Mr. Glass provided a review of trading costs compared to Plexus benchmark data for the active international managers, noting that overall total execution costs were higher than the benchmark by about 100 bp, above-average returns on stock picks have diminished over time, costs eat up most short-term alpha, and managers' use of brokers was expensive. Mr. Glass noted that Plexus' reports provide insight to the soundness of managers' process, with trading costs more consistent than investment returns and inefficient trading costs usually systematic. He reviewed the summary of Plexus' findings, noting that four of the six active international managers stood out for such things as trade execution, improving cost trends, stock picks, and utilization of brokers. Suggested follow-up related to exploring the process for initiating and completing trades, and monitoring for cost trends and external liquidity constraints. Discussion ensued regarding the value of evaluating trading costs in monitoring manager performance and about some of the inherent limitations of such analyses.

**PUBLIC EQUITY – WATCHLIST UPDATE**

Mr. Bruebaker informed the Committee that staff placed F&C Emerging Markets Limited on watchlist for poor performance subsequent to the mailing of the meeting materials. He provided a brief update on the performance of Schroder Investment Management North America.

**PUBLIC EQUITY – BENCHMARK REVIEW UPDATE**

Mr. Bruebaker stated there was no new information to provide for the benchmark review, that new information should be available regarding MSCI changes in mid-March, and that staff would continue to brief the Committee on any new developments until such time as conclusive information is available and staff makes their final recommendation to the Committee.

**OTHER ITEMS**

There being no further business to come before the Public Markets Committee, the meeting adjourned at 4:57 P.M.